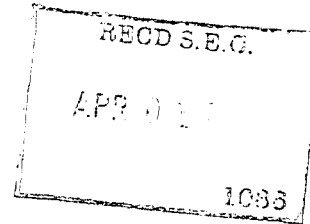




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# GRAYSON BANKSHARES, INC.

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## 2003 ANNUAL REPORT

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FINANCIAL

# 2003 Annual Report

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## Stockholder Information

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### Annual Meeting

The annual meeting of stockholders will be held at 1:00 p.m. on April 13, 2004, at the Grayson National Bank Conference Center, 558 East Main Street, Independence, Virginia, located in the Guynn Shopping Center.

### Requests for Information

Requests for information should be directed to Mrs. Brenda C. Smith, Corporate Secretary, at The Grayson National Bank, Post Office Box 186, Independence, Virginia, 24348; telephone (276) 773-2811.

### Independent Auditors

Larowe & Company, PLC  
Certified Public Accountants  
Post Office Box 760  
Galax, Virginia 24333

### Stock Transfer Agent

The Grayson National Bank  
Post Office Box 186  
Independence, VA 24348

### Federal Deposit Insurance Corporation

The Bank is a member of the FDIC. This statement has not been reviewed, or confirmed for accuracy or relevance by the Federal Deposit Insurance Corporation.

### Banking Offices

#### **Main Office**

113 West Main Street  
Independence, Virginia 24348  
(276) 773-2811

#### **East Independence Office**

802 East Main Street  
Independence, Virginia 24348  
(276) 773-2811

#### **Galax Office**

209 West Grayson Street  
Galax, Virginia  
(276) 238-2411

#### **Carroll Office**

8351 Carrollton Pike  
Galax, Virginia 24333  
(276) 238-8112

#### **Elk Creek Office**

60 Comers Rock Road  
Elk Creek, Virginia 24326  
(276) 655-4011

#### **Troutdale Office**

101 Ripshin Road  
Troutdale, Virginia 24378  
(276) 677-3722

#### **Sparta Office**

98 South Grayson Street  
Sparta, North Carolina 28675  
(336) 372-2811

## Financial Highlights<sup>1</sup>

	2003	2002	2001	2000	1999
<b>Summary of Operations</b>					
Interest income	\$ 13,842	\$ 14,280	\$ 13,717	\$ 13,153	\$ 11,655
Interest expense	<u>5,637</u>	<u>6,640</u>	<u>7,204</u>	<u>6,785</u>	<u>5,921</u>
Net interest income	8,205	7,640	6,513	6,368	5,734
Provision for credit losses	410	441	280	280	300
Other income	2,662	1,021	589	435	347
Other expense	5,812	4,720	4,092	3,772	3,371
Income taxes	<u>1,306</u>	<u>964</u>	<u>790</u>	<u>687</u>	<u>466</u>
Net income	<u>\$ 3,339</u>	<u>\$ 2,536</u>	<u>\$ 1,940</u>	<u>\$ 2,064</u>	<u>\$ 1,944</u>

### Per Share Data<sup>2</sup>

Net income	\$ 1.94	\$ 1.48	\$ 1.13	\$ 1.20	\$ 1.13
Cash dividends declared	1.00	.46	.41	.37	.33
Book value	14.31	13.51	12.27	11.42	10.41
Estimated market value <sup>3</sup>	32.00	32.00	29.00	32.00	32.00

### Year-end Balance Sheet Summary

Loans, net	\$ 176,155	\$ 154,190	\$ 140,898	\$ 133,072	\$ 121,498
Investment securities	46,282	44,872	33,452	28,766	29,430
Total assets	263,865	241,283	201,469	180,318	170,335
Deposits	228,219	206,909	179,323	159,590	151,620
Stockholders' equity	24,601	23,230	21,086	19,638	17,890

### Selected Ratios

Return on average assets	1.32%	1.13%	1.02%	1.18%	1.18%
Return on average equity	13.66%	11.40%	9.44%	10.95%	11.05%
Average equity to average assets	9.66%	9.88%	10.85%	10.75%	10.69%

<sup>1</sup> In thousands of dollars, except per share data.

<sup>2</sup> Adjusted for the effects of a two for one stock split in 1999.

<sup>3</sup> Provided at the trade date nearest year end.

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## **GRAYSON BANKSHARES, INC.**

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*P. O. Box 186, Independence, Va. 24348*

Dear Stockholders:

It is our pleasure to present our Annual Financial Report to you.

We ended the year with total assets of \$263,864,928, resulting in an increase of \$22,582,339 or 9.36% over the previous year. Our return on assets was 1.32% and the return on equity was 13.66% as compared to 1.13% and 11.40% for the previous year. Net earnings were \$3,338,559, an increase of \$802,100 or 31.62% compared to the previous year. Our deposits increased \$21,310,624 or 10.30% and net loans increased \$21,964,725 or 14.25%. Please refer to our financial highlights page and accompanying statements for additional information.

The book value of our stock at year-end was \$14.31 and stock trades nearest year-end were executed at \$32.00 per share. Dividends for the year were \$1.00 per share, up 54 cents per share over 2002. Dividends for the year included a special dividend of 50 cents per share which was paid in December.

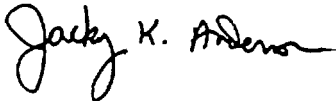
Last year was a busy year that was marked with many accomplishments. We opened our new East Independence Branch in April and our Carroll County Branch in August. Grand opening celebrations were held at both branches where the turnouts far exceeded even our best expectations. We have also completed a renovation and conversion of the old East Independence Branch into the new Grayson National Bank Conference Center where we plan to hold our 2004 annual meeting of shareholders. The Conference Center will be used for various board and committee meetings as well as continued education and training sessions for bank employees. Work is underway now on our new Hillsville Branch and we anticipate opening sometime in late summer or early fall of this year.

We continued our efforts to keep our technology at the forefront of industry standards. In 2003 the Bank installed a new check imaging system and our own backup main frame. These additions will increase our record storage capacity, speed up our data retrieval and better insure the safety of our records in the event of a disaster. Check imaging also gives the customer the convenience of receiving full-page copies of cancelled checks for easy filing and reference. It is always our goal to offer customers a wide range of products along with the convenience and personal service of a community bank, and to that end, we continue to evaluate new products and services on an ongoing basis.

Your bank is blessed with great personnel at all of its branches and I know that all of you, like myself, appreciate each and every one of them. I wish to thank our employees for their dedicated service to the bank, our shareholders and most of all, our customers.

As always, we appreciate your support, welcome your comments and the opportunity to serve you.

Sincerely,



Jacky K. Anderson  
President & CEO



Post Office Box 760  
Cranberry Office Park  
104 Cranberry Road  
Galax, Virginia 24333  
276-238-1800  
Fax 276-238-1801

### **Independent Auditor's Report**

Board of Directors and Stockholders  
Grayson Bankshares, Inc.  
Independence, Virginia

We have audited the consolidated balance sheets of Grayson Bankshares, Inc. and subsidiary as of December 31, 2003 and 2002 and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Grayson Bankshares, Inc. and subsidiary at December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

*Larowe & Company, P.L.C.*

Galax, Virginia  
February 5, 2004

## Consolidated Balance Sheets

December 31, 2003 and 2002

Assets	2003	2002
Cash and due from banks	\$ 11,748,140	\$ 11,265,444
Federal funds sold	15,305,544	19,740,228
Investment securities available for sale	41,239,131	40,120,124
Investment securities held to maturity	3,960,887	3,906,401
Restricted equity securities	1,081,750	845,450
Loans, net of allowance for loan losses of \$2,395,387 in 2003 and \$2,189,028 in 2002	176,154,730	154,190,005
Cash value of life insurance	4,677,731	4,423,418
Foreclosed assets	15,000	-
Property and equipment, net	6,228,192	4,126,234
Accrued income	1,891,116	1,798,906
Other assets	1,562,707	866,379
	<u>\$ 263,864,928</u>	<u>\$ 241,282,589</u>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Deposits		
Noninterest-bearing	\$ 26,708,360	\$ 22,950,583
Interest-bearing	201,510,788	183,957,941
Total deposits	<u>228,219,148</u>	<u>206,908,524</u>
Long-term debt	10,000,000	10,000,000
Accrued interest payable	264,640	328,975
Other liabilities	780,344	815,573
	<u>239,264,132</u>	<u>218,053,072</u>
Commitments and contingencies		
<b>Stockholders' equity</b>		
Preferred stock, \$25 par value; 500,000 shares authorized; none issued	-	-
Common stock, \$1.25 par value; 5,000,000 shares authorized; 1,718,968 shares issued in 2003 and 2002, respectively	2,148,710	2,148,710
Surplus	521,625	521,625
Retained earnings	21,587,202	19,967,611
Accumulated other comprehensive income	343,259	591,571
	<u>24,600,796</u>	<u>23,229,517</u>
	<u>\$ 263,864,928</u>	<u>\$ 241,282,589</u>

# Consolidated Statements of Income

Years ended December 31, 2003, 2002 and 2001

	2003	2002	2001
<b>Interest income:</b>			
Loans and fees on loans	\$ 11,595,816	\$ 11,798,933	\$ 11,759,838
Federal funds sold	245,760	239,255	335,795
Investment securities:			
Taxable	1,545,643	1,803,674	1,154,379
Exempt from federal income tax	454,938	438,515	467,319
	<u>13,842,157</u>	<u>14,280,377</u>	<u>13,717,331</u>
<b>Interest expense:</b>			
Deposits	5,123,483	6,197,872	7,204,506
Interest on borrowings	<u>513,639</u>	<u>442,067</u>	-
	<u>5,637,122</u>	<u>6,639,939</u>	<u>7,204,506</u>
Net interest income	8,205,035	7,640,438	6,512,825
<b>Provision for loan losses</b>	<u>410,000</u>	<u>441,000</u>	<u>280,000</u>
Net interest income after provision for loan losses	<u>7,795,035</u>	<u>7,199,438</u>	<u>6,232,825</u>
<b>Noninterest income:</b>			
Service charges on deposit accounts	429,135	354,644	332,761
Other service charges and fees	534,537	437,263	74,239
Net realized gains on securities	919,710	3,735	5,587
Other income	<u>778,266</u>	<u>225,659</u>	<u>176,441</u>
	<u>2,661,648</u>	<u>1,021,301</u>	<u>589,028</u>
<b>Noninterest expense:</b>			
Salaries and employee benefits	3,687,447	2,985,573	2,556,392
Occupancy expense	180,119	127,153	121,002
Equipment expense	501,658	391,390	369,895
Other expense	<u>1,443,365</u>	<u>1,216,061</u>	<u>1,045,113</u>
	<u>5,812,589</u>	<u>4,720,177</u>	<u>4,092,402</u>
Income before income taxes	4,644,094	3,500,562	2,729,451
<b>Income tax expense</b>	<u>1,305,535</u>	<u>964,103</u>	<u>789,551</u>
Net income	<u>\$ 3,338,559</u>	<u>\$ 2,536,459</u>	<u>\$ 1,939,900</u>
<b>Basic earnings per share</b>	<u>\$ 1.94</u>	<u>\$ 1.48</u>	<u>\$ 1.13</u>
<b>Weighted average shares outstanding</b>	<u>1,718,968</u>	<u>1,718,968</u>	<u>1,718,968</u>



# Consolidated Statements of Stockholders' Equity

Years ended December 31, 2003, 2002 and 2001

	<u>Common Stock</u>		<u>Surplus</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>				
<b>Balance, December 31, 2000</b>	1,718,968	\$2,148,710	\$ 521,625	\$ 16,986,754	\$ (19,428)	\$ 19,637,661
<b>Comprehensive income</b>						
Net income	-	-	-	1,939,900	-	1,939,900
Net change in unrealized appreciation (depreciation) on investment securities available for sale, net of taxes of \$ 107,822	-	-	-	-	216,676	216,676
Reclassification adjustment, net of income taxes of \$ 1,900	-	-	-	-	(3,687)	(3,687)
<b>Total comprehensive income</b>						2,152,889
Dividends paid (\$ .41 per share)	-	-	-	(704,777)	-	(704,777)
<b>Balance, December 31, 2001</b>	1,718,968	2,148,710	521,625	18,221,877	193,561	21,085,773
<b>Comprehensive income</b>						
Net income	-	-	-	2,536,459	-	2,536,459
Net change in unrealized appreciation (depreciation) on investment securities available for sale, net of taxes of \$ 203,765	-	-	-	-	400,475	400,475
Reclassification adjustment, net of income taxes of \$ 1,270	-	-	-	-	(2,465)	(2,465)
<b>Total comprehensive income</b>						2,934,469
Dividends paid (\$ .46 per share)	-	-	-	(790,725)	-	(790,725)
<b>Balance, December 31, 2002</b>	1,718,968	2,148,710	521,625	19,967,611	591,571	23,229,517
<b>Comprehensive income</b>						
Net income	-	-	-	3,338,559	-	3,338,559
Net change in unrealized appreciation (depreciation) on investment securities available for sale, net of taxes of \$184,783	-	-	-	-	358,697	358,697
Reclassification adjustment, net of income taxes of \$312,701	-	-	-	-	(607,009)	(607,009)
<b>Total comprehensive income</b>						3,090,247
Dividends paid (\$1.00 per share)	-	-	-	(1,718,968)	-	(1,718,968)
<b>Balance, December 31, 2003</b>	<u>1,718,968</u>	<u>\$2,148,710</u>	<u>\$ 521,625</u>	<u>\$ 21,587,202</u>	<u>\$ 343,259</u>	<u>\$ 24,600,796</u>

# Consolidated Statements of Cash Flows

Years ended December 31, 2003, 2002 and 2001

	2003	2002	2001
<b>Cash flows from operating activities</b>			
Net income	\$ 3,338,559	\$ 2,536,459	\$ 1,939,900
Adjustments to reconcile net income to net cash provided by operations:			
Depreciation and amortization	409,525	319,320	294,828
Provision for loan losses	410,000	441,000	280,000
Deferred income taxes	(40,580)	(108,478)	18,781
Net realized gains on securities	(919,710)	(3,735)	(5,587)
Accretion of discount on securities, net of amortization of premiums	248,727	131,135	40,577
Deferred compensation	11,475	7,594	11,198
Changes in assets and liabilities:			
Cash value of life insurance	(254,313)	(224,834)	-
Accrued income	(92,210)	(85,262)	(31,734)
Other assets	(527,830)	(21,343)	(77,849)
Accrued interest payable	(64,335)	61,177	(26,785)
Other liabilities	(46,704)	15,392	(14,079)
Net cash provided by operating activities	<u>2,472,604</u>	<u>3,068,425</u>	<u>2,429,250</u>
<b>Cash flows from investing activities</b>			
Net (increase) decrease in federal funds sold	4,434,684	(7,104,182)	(4,815,608)
Activity in available for sale securities:			
Purchases	(23,342,538)	(20,833,587)	(14,511,753)
Sales	11,964,172	1,542,321	2,401,126
Maturities	10,547,217	5,651,348	5,180,475
Activity in held to maturity securities:			
Purchases	(2,215,694)	(92,825)	(598,867)
Maturities	2,168,103	2,808,090	3,875,000
Purchases of restricted equity securities	(236,300)	(19,700)	(744,000)
Net increase in loans	(22,389,725)	(13,733,164)	(8,105,952)
Purchases of property and equipment, net of sales	(2,511,483)	(1,531,556)	(415,845)
Purchase of bank-owned life insurance	-	(4,000,000)	-
Net cash used in investing activities	<u>(21,581,564)</u>	<u>(37,313,255)</u>	<u>(17,735,424)</u>
<b>Cash flows from financing activities</b>			
Net increase in deposits	21,310,624	27,585,542	19,732,882
Dividends paid	(1,718,968)	(790,725)	(704,777)
Net increase in long-term debt	-	10,000,000	-
Net cash provided by financing activities	<u>19,591,656</u>	<u>36,794,817</u>	<u>19,028,105</u>
Net increase in cash and cash equivalents	482,696	2,549,987	3,721,931
<b>Cash and cash equivalents, beginning</b>	<u>11,265,444</u>	<u>8,715,457</u>	<u>4,993,526</u>
<b>Cash and cash equivalents, ending</b>	<u>\$ 11,748,140</u>	<u>\$ 11,265,444</u>	<u>\$ 8,715,457</u>
<b>Supplemental disclosure of cash flow information</b>			
Interest paid	\$ 5,701,457	\$ 6,578,762	\$ 7,231,291
Taxes paid	\$ 1,443,179	\$ 1,028,309	\$ 759,900
<b>Supplemental disclosure of noncash investing activities</b>			
Effect on equity of change in net unrealized gain	\$ (248,312)	\$ 398,010	\$ 212,989

See Notes to Consolidated Financial Statements

# Notes to Consolidated Financial Statements

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## **Note 1. Organization and Summary of Significant Accounting Policies**

### ***Organization***

Grayson Bankshares, Inc. (the Company) was incorporated as a Virginia corporation on February 3, 1992 to acquire the stock of The Grayson National Bank (the Bank). The Bank was acquired by the Company on July 1, 1992.

The Grayson National Bank was organized under the laws of the United States in 1900 and currently serves Grayson County, Virginia and surrounding areas through seven banking offices. As an FDIC insured, National Banking Association, the Bank is subject to regulation by the Comptroller of the Currency. The Company is regulated by the Federal Reserve.

The accounting and reporting policies of the Company and the Bank follow generally accepted accounting principles and general practices within the financial services industry. Following is a summary of the more significant policies.

### ***Critical accounting policies***

The notes to our audited consolidated financial statements for the year ended December 31, 2003 included herein, contain a summary of our significant accounting policies. We believe our policies with respect to the methodology for our determination of the allowance for loan losses, and asset impairment judgments involve a higher degree of complexity and require management to make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could cause reported results to differ materially. These critical policies and their application are periodically reviewed with the Audit Committee and our Board of Directors.

### ***Principles of Consolidation***

The consolidated financial statements include the accounts of the Company and the Bank, which is wholly owned. All significant, intercompany transactions and balances have been eliminated in consolidation.

### ***Business Segments***

The Company reports its activities as a single business segment. In determining the appropriateness of segment definition, the Company considers components of the business about which financial information is available and regularly evaluated relative to resource allocation and performance assessment.

### ***Use of Estimates***

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowances for loan and foreclosed real estate losses, management obtains independent appraisals for significant properties.

Substantially all of the Bank's loan portfolio consists of loans in its market area. Accordingly, the ultimate collectibility of a substantial portion of the Bank's loan portfolio and the recovery of a substantial portion of the carrying amount of foreclosed real estate are susceptible to changes in local market conditions. The regional economy is diverse, but influenced to an extent by the manufacturing and agricultural segments.

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## Notes to Consolidated Financial Statements

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### **Note 1. Organization and Summary of Significant Accounting Policies, continued**

#### ***Use of Estimates, continued***

While management uses available information to recognize loan and foreclosed real estate losses, future additions to the allowances may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as a part of their routine examination process, periodically review the Bank's allowances for loan and foreclosed real estate losses. Such agencies may require the Bank to recognize additions to the allowances based on their judgments about information available to them at the time of their examinations. Because of these factors, it is reasonably possible that the allowances for loan and foreclosed real estate losses may change materially in the near term.

#### ***Cash and Cash Equivalents***

For the purpose of presentation in the consolidated statements of cash flows, cash and cash equivalents are defined as those amounts included in the balance sheet caption "cash and due from banks."

#### ***Trading Securities***

The Company does not hold securities for short-term resale and therefore does not maintain a trading securities portfolio.

#### ***Securities Held to Maturity***

Bonds, notes, and debentures for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for premiums and discounts that are recognized in interest income using the interest method over the period to maturity or to call dates.

#### ***Securities Available for Sale***

Available for sale securities are reported at fair value and consist of bonds, notes, debentures, and certain equity securities not classified as trading securities or as held to maturity securities.

Unrealized holding gains and losses, net of tax, on available for sale securities are reported as a net amount in a separate component of shareholders' equity. Realized gains and losses on the sale of available for sale securities are determined using the specific-identification method. Premiums and discounts are recognized in interest income using the interest method over the period to maturity or to call dates.

Declines in the fair value of individual held to maturity and available for sale securities below cost that are other than temporary are reflected as write-downs of the individual securities to fair value. Related write-downs are included in earnings as realized losses.

#### ***Loans Held for Sale***

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated market value in the aggregate. Net unrealized losses are recognized through a valuation allowance by charges to income. The Company had no loans held for sale at December 31, 2003 or 2002.

#### ***Loans Receivable***

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding principal amount adjusted for any charge-offs and the allowance for loan losses. Loan origination fees and costs, are not capitalized and recognized as an adjustment to the yield on the related loan as such deferrals are not material to the Company's financial position or results of operations.

## Notes to Consolidated Financial Statements

### Note 1. Organization and Summary of Significant Accounting Policies, continued

#### *Loans Receivable, continued*

Interest is accrued and credited to income based on the principal amount outstanding. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received. When facts and circumstances indicate the borrower has regained the ability to meet the required payments, the loan is returned to accrual status. Past due status of loans is determined based on contractual terms.

#### *Allowance for Loan Losses*

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

#### *Property and Equipment*

Land is carried at cost. Bank premises, furniture and equipment, and leasehold improvements are carried at cost, less accumulated depreciation and amortization computed principally by the straight-line method over the following estimated useful lives:

	<u>Years</u>
Buildings and improvements	10-40
Furniture and equipment	5-12

#### *Foreclosed Assets*

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value less anticipated cost to sell at the date of foreclosure establishing a new cost basis. After foreclosure, valuations are periodically performed by management and the real estate is carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in loss on foreclosed real estate. The historical average holding period for such properties is less than six months.

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## Notes to Consolidated Financial Statements

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### **Note 1. Organization and Summary of Significant Accounting Policies, continued**

#### ***Pension Plan***

The Bank maintains a noncontributory defined benefit pension plan covering all employees who meet eligibility requirements. To be eligible, an employee must be 21 years of age and have completed one year of service. Plan benefits are based on final average compensation and years of service. The funding policy is to contribute the maximum deductible for federal income tax purposes.

#### ***Transfers of Financial Assets***

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

#### ***Income Taxes***

Provision for income taxes is based on amounts reported in the statements of income (after exclusion of non-taxable income such as interest on state and municipal securities) and consists of taxes currently due plus deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred taxes assets and liabilities are adjusted through the provision for income taxes.

Deferred income tax liability relating to unrealized appreciation (or the deferred tax asset in the case of unrealized depreciation) on investment securities available for sale is recorded in other liabilities (assets). Such unrealized appreciation or depreciation is recorded as an adjustment to equity in the financial statements and not included in income determination until realized. Accordingly, the resulting deferred income tax liability or asset is also recorded as an adjustment to equity.

#### ***Basic Earnings per Share***

Basic earnings per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding during the period, after giving retroactive effect to stock splits and dividends.

#### ***Diluted Earnings per Share***

The computation of diluted earnings per share is similar to the computation of basic earnings per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if dilutive potential common shares had been issued. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of those potential common shares. For the years presented, the Company has no potentially dilutive securities outstanding.

#### ***Comprehensive Income***

Annual comprehensive income reflects the change in the Company's equity during the year arising from transactions and events other than investments by and distributions to shareholders. It consists of net income plus certain other changes in assets and liabilities that are reported as separate components of shareholders' equity rather than as income or expense.

## Notes to Consolidated Financial Statements

### Note 1. Organization and Summary of Significant Accounting Policies, continued

#### **Financial Instruments**

*Credit related financial instruments:* In the ordinary course of business, the Bank has entered into commitments to extend credit, including commitments under line of credit arrangements, commercial letters of credit and standby letters of credit. Such financial instruments are recorded when they are funded.

*Derivative financial instruments designated as hedges:* As part of the Bank's asset/liability management, the Bank uses interest rate contracts, which include, swaps, futures, forwards and option agreements to hedge various exposures or to modify interest rate characteristics of various balance sheet accounts.

Derivatives that are used as part of the asset/liability management process are linked to specific assets or liabilities and have high correlation between the contract and the underlying item being hedged, both at inception and throughout the hedge period. In addition, forwards and option contracts must reduce an exposure's risk, and for hedges of anticipatory transactions, the significant terms and characteristics of the transaction must be identified and the transactions must be probable of occurring.

The derivative instruments that meet the preceding qualifications are accounted for as follows:

- ◆ Swaps and options are accounted for on the "accrual" method. Under that method, the interest component associated with the contract is recognized over the life of the contract in net interest income. Except for contracts designated as a hedge of an available-for-sale security, swaps and options are not carried at fair value. For contracts that are designated as a hedge of an available-for-sale security, in addition to the accrual method of accounting, these contracts are carried at fair value with the resulting gain or loss recognized in other comprehensive income. Option premiums paid are amortized to net interest income over the life of the contract.
- ◆ Futures and forwards are carried at fair value with the resulting gain or loss deferred and recognized in net interest income in a manner consistent with the objectives of the use of the instrument.
- ◆ When a contract is terminated the resulting gain or loss is deferred and amortized into net interest income based upon the shorter of the contract's life or the underlying hedged item. If the underlying hedged item is disposed, the deferred gain or loss is immediately recognized as part of the gain or loss on the disposed item.

*Other derivative financial instruments:* Those contracts that do not meet the hedging criteria above are classified as trading activities and are recorded at fair value with changes in fair value recorded in earnings.

#### **Fair Value of Financial Instruments**

Statement of Financial Accounting Standards No. 107, Disclosures about Fair Value of Financial Instruments, requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Statement No. 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

*Cash and cash equivalents:* The carrying amounts reported in the balance sheet for cash and cash equivalents approximate their fair values.

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## Notes to Consolidated Financial Statements

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### **Note 1. Organization and Summary of Significant Accounting Policies, continued**

*Interest-bearing deposits with banks:* Fair values for time deposits are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated contractual maturities on such time deposits.

*Available-for-sale and held-to-maturity securities:* Fair values for securities, excluding restricted equity securities, are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. The carrying values of restricted equity securities approximate fair values.

*Loans receivable:* For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying amounts. The fair values for other loans are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Loan fair value estimates include judgments regarding future expected loss experience and risk characteristics. Fair values for impaired loans are estimated using discounted cash flow analysis or underlying collateral values, where applicable. The carrying amount of accrued interest receivable approximates its fair value.

*Deposit liabilities:* The fair values disclosed for demand and savings deposits are, by definition, equal to the amount payable on demand at the reporting date. The fair values for certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated contractual maturities on such time deposits. The carrying amount of accrued interest payable approximates fair value.

*Short-term debt:* The carrying amounts of short-term debt approximate their fair values.

*Long-term debt:* The fair value of long-term debt is estimated using a discounted cash flow calculation that applies interest rates currently available on similar instruments.

*Other liabilities:* For fixed-rate loan commitments, fair value considers the difference between current levels of interest rates and the committed rates. The carrying amounts of other liabilities approximate fair value.

*Derivatives:* The fair value of derivatives is determined by comparing current market prices for similar contracts with contracts entered by the Company.

### ***Reclassification***

Certain reclassifications have been made to the prior years' financial statements to place them on a comparable basis with the current presentation. Net income and stockholders' equity previously reported were not affected by these reclassifications.

### ***Advertising Expense***

The Company expenses advertising costs as they are incurred. Advertising expense for the years presented are not material.

### **Note 2. Restrictions on Cash**

To comply with banking regulations, the Bank is required to maintain certain average cash reserve balances. The daily average cash reserve requirement was approximately \$797,000 and \$658,000 for the periods including December 31, 2003 and 2002, respectively.



## Notes to Consolidated Financial Statements

### Note 3. Investment Securities

Debt and equity securities have been classified in the consolidated balance sheets according to management's intent. The carrying amount of securities and their approximate fair values at December 31 follow:

	<u>Amortized Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
<b>2003</b>				
<i>Available for sale:</i>				
U.S. Government agency securities	\$ 14,157,022	\$ 66,517	\$ 251,086	\$ 13,972,453
Mortgage-backed securities	2,813,419	74,623	-	2,888,042
State and municipal securities	11,842,245	399,916	28,093	12,214,068
Corporate securities	11,906,355	297,818	39,605	12,164,568
	<u>\$ 40,719,041</u>	<u>\$ 838,874</u>	<u>\$ 318,784</u>	<u>\$ 41,239,131</u>
<i>Held to maturity:</i>				
State and municipal securities	<u>\$ 3,960,887</u>	<u>\$ 69,110</u>	<u>\$ 32,650</u>	<u>\$ 3,997,347</u>
<b>2002</b>				
<i>Available for sale:</i>				
U.S. Government agency securities	\$ 3,475,602	\$ 117,924	\$ -	\$ 3,593,526
Mortgage-backed securities	15,993,471	148,286	3,570	16,138,187
State and municipal securities	12,229,325	425,579	79,238	12,575,666
Corporate securities	7,525,407	287,338	-	7,812,745
	<u>\$ 39,223,805</u>	<u>\$ 979,127</u>	<u>\$ 82,808</u>	<u>\$ 40,120,124</u>
<i>Held to maturity:</i>				
State and municipal securities	<u>\$ 3,906,401</u>	<u>\$ 92,052</u>	<u>\$ 5,264</u>	<u>\$ 3,993,189</u>

There were no securities transferred between the available for sale and held to maturity portfolios during 2003, 2002 or 2001.

Restricted equity securities were \$1,081,750 and \$845,450 at December 31, 2003 and 2002, respectively. Restricted equity securities consist of investments in stock of the Federal Home Loan Bank of Atlanta ("FHLB"), Community Bankers Bank, and the Federal Reserve Bank of Richmond, all of which are carried at cost. All of these entities are upstream correspondents of the Bank. The FHLB requires financial institutions to make equity investments in the FHLB in order to borrow money. The Bank is required to hold that stock so long as it borrows from the FHLB. The Federal Reserve requires Banks to purchase stock as a condition for membership in the Federal Reserve system. The Bank's stock in The Bankers Bank is restricted only in the fact that the stock may only be repurchased by The Bankers Bank.

The following table details unrealized losses and related fair values in the Bank's held to maturity and available for sale investment securities portfolios. This information is aggregated by the length of time that individual securities have been in a continuous unrealized loss position as of December 31, 2003.

	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
U.S. Government agency securities	\$ 9,255,469	\$ 251,086	\$ -	\$ -	\$ 9,255,469	\$ 251,086
State and municipal securities	2,626,442	60,743	-	-	2,626,442	60,743
Other securities	3,198,362	39,605	-	-	3,198,362	39,605
Total temporarily impaired securities	<u>\$15,080,273</u>	<u>\$ 351,434</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$15,080,273</u>	<u>\$ 351,434</u>

Management considers the nature of the investment, the underlying causes of the decline in market value, the severity and duration of the decline in market value and other evidence, on a security by security basis, in determining if the decline in market value is other than temporary. Management believes all unrealized losses presented in the table above to be temporary in nature.

## Notes to Consolidated Financial Statements

### Note 3. Investment Securities, continued

Investment securities with amortized cost of approximately \$1,628,000 and \$1,690,000 at December 31, 2003 and 2002, respectively, were pledged as collateral on public deposits and for other purposes as required or permitted by law.

Gross realized gains and losses for the years ended December 31, 2003, 2002 and 2001 are as follows:

	2003	2002	2001
Realized gains	\$ 919,710	\$ 59,037	\$ 15,587
Realized losses	-	(55,302)	(10,000)
	<u>\$ 919,710</u>	<u>\$ 3,735</u>	<u>\$ 5,587</u>

The scheduled maturities of securities available for sale and securities held to maturity at December 31, 2003, were as follows:

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 8,587,225	\$ 8,620,489	\$ 1,005,078	\$ 1,025,566
Due after one year through five years	15,934,601	16,463,830	25,058	25,316
Due after five years through ten years	7,245,609	7,367,312	2,122,768	2,146,544
Due after ten years	8,951,606	8,787,500	807,983	799,921
	<u>\$ 40,719,041</u>	<u>\$ 41,239,131</u>	<u>\$ 3,960,887</u>	<u>\$ 3,997,347</u>

Maturities of mortgage backed securities are based on contractual amounts. Actual maturity will vary as loans underlying the securities are prepaid.

### Note 4. Loans Receivable

The major components of loans in the consolidated balance sheets at December 31, 2003 and 2002 are as follows (in thousands):

	2003	2002
Commercial	\$ 15,093	\$ 13,960
Real estate:		
Construction and land development	14,530	6,040
Residential, 1-4 families	83,824	73,135
Residential, 5 or more families	321	140
Farmland	15,640	7,546
Nonfarm, nonresidential	31,902	35,014
Agricultural	3,152	4,997
Consumer	13,040	14,753
Other	<u>1,048</u>	<u>794</u>
	178,550	156,379
Allowance for loan losses	<u>(2,395)</u>	<u>(2,189)</u>
	<u>\$ 176,155</u>	<u>\$ 154,190</u>

## Notes to Consolidated Financial Statements

### Note 5. Allowance for Loan Losses

An analysis of the allowance for loan losses as of December 31 follows:

	2003	2002	2001
Balance, beginning	\$ 2,189,028	\$ 1,821,966	\$ 1,760,999
Provision charged to expense	410,000	441,000	280,000
Recoveries of amounts charged off	103,782	190,065	88,859
Amounts charged off	(307,423)	(264,003)	(307,892)
Balance, ending	<u>\$ 2,395,387</u>	<u>\$ 2,189,028</u>	<u>\$ 1,821,966</u>

The following is a summary of information pertaining to impaired loans at December 31:

	2003	2002
Impaired loans without a valuation allowance	\$ 3,118,002	\$ 2,611,807
Impaired loans with a valuation allowance	641,779	461,568
Total impaired loans	<u>\$ 3,759,781</u>	<u>\$ 3,073,375</u>
Valuation allowance related to impaired loans	<u>\$ 144,629</u>	<u>\$ 133,306</u>

Nonaccrual loans and loans past due 90 days or more at December 31, 2003 were approximately \$1,435,000 and \$2,119,000, respectively. At December 31, 2002, those amounts were approximately \$649,000 and \$1,883,000, respectively.

The average annual recorded investment in impaired loans and interest income recognized on impaired loans for the years ended December 31, 2003, 2002 and 2001 (all approximate) is summarized below:

	2003	2002	2001
Average investment in impaired loans	\$ 2,116,478	\$ 1,496,239	\$ 1,304,678
Interest income recognized on impaired loans	<u>\$ 193,635</u>	<u>\$ 154,810</u>	<u>\$ 181,609</u>
Interest income recognized on a cash basis on impaired loans	<u>\$ 109,711</u>	<u>\$ 82,391</u>	<u>\$ 133,868</u>

No additional funds are committed to be advanced in connection with impaired loans.

### Note 6. Property and Equipment

Components of property and equipment and total accumulated depreciation at December 31, 2003 and 2002, are as follows:

	2003	2002
Land	\$ 1,226,339	\$ 809,136
Buildings and improvements	3,920,221	2,753,822
Furniture and equipment	3,715,468	2,787,587
	<u>8,862,028</u>	<u>6,350,545</u>
Less accumulated depreciation	(2,633,836)	(2,224,311)
	<u>\$ 6,228,192</u>	<u>\$ 4,126,234</u>

### Note 7. Cash Value of Life Insurance

The Bank is owner and beneficiary of life insurance policies on certain employees and directors. Policy cash values included in other assets totaled \$4,677,731 and \$4,423,418 at December 31, 2003 and 2002, respectively.

## Notes to Consolidated Financial Statements

### Note 8. Deposits

The aggregate amount of time deposits in denominations of \$100,000 or more at December 31, 2003 and 2002 was \$34,695,733 and \$35,232,988, respectively. At December 31, 2003, the scheduled maturities of time deposits are as follows:

Three months or less	\$ 27,713,097
Over three months through twelve months	66,294,561
Over one year through three years	34,727,798
Over three years	-
	<u>\$ 128,735,456</u>

### Note 9. Short-Term Debt

The Bank has established unsecured lines of credit with correspondent banks totaling approximately \$10,146,000 and a secured line of credit with the Federal Home Loan Bank of Atlanta of approximately \$29,392,000. At December 31, 2003 and 2002, no amounts were outstanding under these arrangements.

### Note 10. Long-Term Debt

The Bank's long-term debt consists of \$10,000,000 borrowed from the Federal Home Loan Bank of Atlanta. The loan matures on January 17, 2012 and is secured by all capital stock and all first mortgage one-to-four family residential loans of approximately \$82,100,000 at December 31, 2003. Interest on the loan is fixed at 4.56% for the first five years at which time the interest rate is convertible, at the option of the Federal Home Loan Bank, to a variable rate equal to the three-month LIBOR rate. If converted, the Bank has the option to prepay the debt without penalty.

### Note 11. Financial Instruments

#### Fair Values

The estimated fair values of the Company's financial instruments are as follows (dollars in thousands):

	December 31, 2003		December 31, 2002	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial assets</b>				
Cash and cash equivalents	\$ 11,748	\$ 11,748	\$ 11,265	\$ 11,265
Federal funds sold	15,306	15,306	19,740	19,740
Securities, available for sale	41,239	41,239	40,120	40,120
Securities, held to maturity	3,961	3,997	3,906	3,993
Restricted equity securities	1,082	1,082	845	845
Loans, net of allowance for credit losses	176,155	175,327	154,190	153,860
<b>Financial liabilities</b>				
Deposits	228,219	228,845	206,909	208,133
Long-term debt	10,000	10,312	10,000	10,331
<b>Off-balance-sheet assets (liabilities)</b>				
Commitments to extend credit and standby letters of credit	-	-	-	-
Derivate financial instruments	-	-	-	-

## Notes to Consolidated Financial Statements

### Note 11. Financial Instruments, continued

#### Interest Swap Agreement

During 2003, in order to better manage interest rate risk, the Bank entered into an agreement whereby the interest expense on variable rate debt totaling \$10,000,000 was swapped for a fixed rate of interest expense. Due to a change in long-term interest rates, the Bank terminated the swap agreement and repaid the related debt during the year. As a result, the Bank recognized a gain of approximately \$522,000 that is included in other income for the year ended December 31, 2003.

### Note 12. Employee Benefit Plan

The Bank has a qualified noncontributory defined benefit pension plan which covers substantially all of its employees. The benefits are primarily based on years of service and earnings. The following is a summary of the plan's funded status as of December 31, 2003 and 2002.

	2003	2002
<b>Change in benefit obligation</b>		
Benefit obligation at beginning of year	\$ 3,116,886	\$ 2,472,763
Service cost	173,885	132,227
Interest cost	218,182	185,457
Actuarial (gain) loss	460,742	328,069
Benefits paid	(260,920)	(1,630)
Benefit obligation at end of year	<u>\$ 3,708,775</u>	<u>\$ 3,116,886</u>
<b>Change in plan assets</b>		
Fair value of plan assets at beginning of year	\$ 1,830,770	\$ 1,745,925
Actual return on plan assets	258,803	(116,096)
Employer contribution	258,063	202,571
Benefits paid	(260,920)	(1,630)
Fair value of plan assets at end of year	<u>\$ 2,086,716</u>	<u>\$ 1,830,770</u>
<b>Change in prepaid (accrued) benefit cost</b>		
Prepaid (accrued) benefit cost, beginning	\$ (90,249)	\$ (110,674)
Contributions	258,063	202,571
Pension cost	(277,171)	(182,146)
Prepaid (accrued) benefit cost, ending	<u>\$ (109,357)</u>	<u>\$ (90,249)</u>
<b>Funded status</b>	<u>\$ (1,622,059)</u>	<u>\$ (1,286,116)</u>
Unrecognized transitional net assets	(203)	(238)
Unrecognized prior service costs	60,386	70,450
Unrecognized net actuarial loss	1,452,519	1,125,655
Prepaid (accrued) benefit cost	<u>\$ (109,357)</u>	<u>\$ (90,249)</u>
<b>Additional disclosure information</b>		
Accumulated benefit obligation	\$ 2,034,649	\$ N/A
Vested benefit obligation	\$ 1,975,682	\$ N/A
Discount rate	6.5%	7.0%
Expected return on plan assets	8.5%	9.0%
Rate of compensation increase	5.0%	5.0%
Average remaining service (years)	18	N/A

It is Bank policy to contribute the maximum tax-deductible amount each year as determined by the plan administrator. Based on current information, it is anticipated the 2004 contribution will be approximately \$1,000,000 and pension cost will be approximately \$350,000.

## Notes to Consolidated Financial Statements

### Note 12. Employee Benefit Plan, continued

	2003	2002	2001
<b>Components of net periodic benefit cost</b>			
Service cost	\$ 173,885	\$ 132,227	\$ 117,643
Interest cost	218,182	185,457	159,290
Return on plan assets	(258,803)	116,096	225,323
Originating unrecognized asset gain (loss)	85,998	(279,703)	(395,092)
Recognized net actuarial (gain) loss	47,880	18,040	-
Amortization	10,029	10,029	10,029
Net periodic benefit cost	<u>\$ 277,171</u>	<u>\$ 182,146</u>	<u>\$ 117,193</u>

### Long-Term Rate of Return

The plan sponsor selects the expected long-term rate-of-return-on-assets assumption in consultation with their investment advisors and actuary, and with concurrence from their auditors. This rate is intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed – especially with respect to real rates of return (net of inflation) – for the major asset classes held, or anticipated to be held by the trust, and for the trust itself. Undue weight is not given to recent experience – that may not continue over the measurement period – with higher significance placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further – solely for this purpose the plan is assumed to continue in force and not terminate during the period during which the assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).

### Asset Allocation

The pension plan's weighted-average asset allocations at September 30, 2003 and 2002, by asset category are as follows:

	2003	2002
<b>Asset Category</b>		
Mutual funds – fixed income	48%	50%
Mutual funds – equity	52%	50%
Other	0%	0%
Total	<u>100%</u>	<u>100%</u>

The trust fund is sufficiently diversified to maintain a reasonable level of risk without imprudently sacrificing return, with a targeted asset allocation of 50% fixed income and 50% equities. The Investment Manager selects investment fund managers with demonstrated experience and expertise, and funds with demonstrated historical performance, for the implementation of the Plan's investment strategy. The Investment Manager will consider both actively and passively managed investment strategies and will allocate funds across the asset classes to develop an efficient investment structure.

It is the responsibility of the Trustee to administer the investments of the Trust within reasonable costs, being careful to avoid sacrificing quality. These costs include, but are not limited to, management and custodial fees, consulting fees, transaction costs and other administrative costs chargeable to the Trust.

## Notes to Consolidated Financial Statements

### Note 13. Deferred Compensation and Life Insurance

Deferred compensation plans have been adopted for certain members of the Board of Directors for future compensation upon retirement. Under plan provisions aggregate annual payments ranging from \$1,992 to \$61,044 are payable for ten years certain, generally beginning at age 65. Reduced benefits apply in cases of early retirement or death prior to the benefit date, as defined. Liability accrued for compensation deferred under the plan amounts to \$527,032 and \$515,557 at December 31, 2003 and 2002, respectively. Expense charged against income was \$53,571, \$55,456 and \$61,944 in 2003, 2002 and 2001, respectively. Charges to income are based on present value of future cash payments, discounted at 8%.

### Note 14. Income Taxes

#### *Current and Deferred Income Tax Components*

The components of income tax expense (substantially all Federal) are as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Current	\$ 1,346,115	\$ 1,072,581	\$ 770,770
Deferred	(40,580)	(108,478)	18,781
	<u>\$ 1,305,535</u>	<u>\$ 964,103</u>	<u>\$ 789,551</u>

#### *Rate Reconciliation*

A reconciliation of income tax expense computed at the statutory federal income tax rate to income tax expense included in the statements of income follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Tax at statutory federal rate	\$ 1,578,992	\$ 1,190,191	\$ 928,013
Tax exempt interest income	(236,015)	(195,153)	(162,031)
State income tax, net of federal benefit	12,716	11,951	9,491
Other	(50,158)	(42,886)	14,078
	<u>\$ 1,305,535</u>	<u>\$ 964,103</u>	<u>\$ 789,551</u>

#### *Deferred Income Tax Analysis*

The significant components of net deferred tax assets (substantially all Federal) at December 31, 2003 and 2002 are summarized as follows:

	<u>2003</u>	<u>2002</u>
<b>Deferred tax assets</b>		
Allowance for loan losses	\$ 726,874	\$ 670,309
Unearned credit life insurance	24,741	25,099
Deferred compensation and accrued pension costs	216,372	205,974
Other	36,240	37,752
	<u>1,004,227</u>	<u>939,134</u>

#### *Deferred tax liabilities*

Net unrealized appreciation on securities available for sale	176,830	304,748
Depreciation	115,734	89,561
Accretion of discount on investment securities	13,150	14,810
	<u>305,714</u>	<u>409,119</u>
Net deferred tax asset	<u>\$ 698,513</u>	<u>\$ 530,015</u>

## Notes to Consolidated Financial Statements

### Note 15. Commitments and Contingencies

#### *Litigation*

In the normal course of business the Bank is involved in various legal proceedings. After consultation with legal counsel, management believes that any liability resulting from such proceedings will not be material to the consolidated financial statements.

#### *Financial Instruments with Off-Balance-Sheet Risk*

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, credit risk in excess of the amount recognized in the consolidated balance sheets.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as for on-balance-sheet instruments. A summary of the Bank's commitments at December 31, 2003 and 2002 is as follows:

	<u>2003</u>	<u>2002</u>
Commitments to extend credit	\$ 8,267,932	\$ 7,308,889
Standby letters of credit	-	-
	<u>\$ 8,267,932</u>	<u>\$ 7,308,889</u>

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies as specified above and is required in instances which the Bank deems necessary.

#### *Concentrations of Credit Risk*

Substantially all of the Bank's loans, commitments to extend credit, and standby letters of credit have been granted to customers in the Bank's market area and such customers are generally depositors of the Bank. Investments in state and municipal securities involve governmental entities within and outside the Bank's market area. The concentrations of credit by type of loan are set forth in Note 4. The distribution of commitments to extend credit approximates the distribution of loans outstanding. Standby letters of credit are granted primarily to commercial borrowers. The Bank's primary focus is toward small business and consumer transactions, and accordingly, it does not have a significant number of credits to any single borrower or group of related borrowers in excess of \$500,000. The Bank has cash and cash equivalents on deposit with financial institutions which exceed federally insured limits.



## Notes to Consolidated Financial Statements

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### **Note 15. Commitments and Contingencies, continued**

#### ***Investment Purchase***

During 2003, the Bank agreed to purchase an equity investment in a limited liability company totaling \$500,000. The Bank has paid \$100,000 as of December 31, 2003 and expects to fund the remaining \$400,000 during 2004.

### **Note 16. Regulatory Restrictions**

#### ***Dividends***

The Company's dividend payments are made from dividends received from the Bank. Under applicable federal law, the Comptroller of the Currency restricts national bank total dividend payments in any calendar year to net profits of that year, as defined, combined with retained net profits for the two preceding years. The Comptroller also has authority under the Financial Institutions Supervisory Act to prohibit a national bank from engaging in an unsafe or unsound practice in conducting its business. It is possible, under certain circumstances, the Comptroller could assert that dividends or other payments would be an unsafe or unsound practice.

#### ***Intercompany Transactions***

The Bank's legal lending limit on loans to the Company is governed by Federal Reserve Act 23A, and differs from legal lending limits on loans to external customers. Generally, a bank may lend up to 10% of its capital and surplus to its Parent, if the loan is secured. If collateral is in the form of stocks, bonds, debentures or similar obligations, it must have a market value when the loan is made of at least 20% more than the amount of the loan, and if obligations of a state or political subdivision or agency thereof, it must have a market value of at least 10% more than the amount of the loan. If such loans are secured by obligations of the United States or agencies thereof, or by notes, drafts, bills of exchange or bankers' acceptances eligible for rediscount or purchase by a Federal Reserve Bank, requirements for collateral in excess of the loan amount do not apply. Under this definition, the legal lending limit for the Bank on loans to the Company was approximately \$2,269,000 at December 31, 2003. No 23A transactions were deemed to exist between the Company and the Bank at December 31, 2003.

#### ***Capital Requirements***

The Company and the Bank are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory (and possibly additional discretionary) actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital to risk-weighted assets, and of Tier I capital to average assets, as all those terms are defined in the regulations. Management believes, as of December 31, 2003, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2003, the most recent notification from the Office of the Comptroller of the Currency categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the following table. There are no conditions or events since that notification that management believes have changed the institution's category.

## Notes to Consolidated Financial Statements

### Note 16. Regulatory Restrictions, continued

#### Capital Requirements, continued

As of December 31, 2003 and 2002, the Bank met the criteria to be considered well capitalized under the regulatory framework from prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the following table.

The Company's and Bank's actual capital amounts (in thousands) and ratios are also presented in the table.

	Actual		Minimum Capital Required		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>December 31, 2003:</b>						
Total Capital						
(to Risk-Weighted Assets)						
Consolidated	\$ 26,449	15.3%	\$ 13,844	8.0%	\$ 17,305	10.0%
Grayson National Bank	\$ 22,451	13.0%	\$ 13,800	8.0%	\$ 17,250	10.0%
Tier I Capital						
(to Risk-Weighted Assets)						
Consolidated	\$ 24,283	14.0%	\$ 6,922	4.0%	\$ 10,383	6.0%
Grayson National Bank	\$ 20,292	11.8%	\$ 6,900	4.0%	\$ 10,350	6.0%
Tier I Capital						
(to Average Assets)						
Consolidated	\$ 24,283	9.3%	\$ 10,408	4.0%	\$ 13,010	5.0%
Grayson National Bank	\$ 20,292	7.8%	\$ 10,368	4.0%	\$ 12,960	5.0%
<b>December 31, 2002:</b>						
Total Capital						
(to Risk-Weighted Assets)						
Consolidated	\$ 24,537	16.1%	\$ 12,211	8.0%	\$ 15,264	10.0%
Grayson National Bank	\$ 19,679	13.0%	\$ 12,133	8.0%	\$ 15,166	10.0%
Tier I Capital						
(to Risk-Weighted Assets)						
Consolidated	\$ 22,638	14.8%	\$ 6,106	4.0%	\$ 9,158	6.0%
Grayson National Bank	\$ 17,780	11.7%	\$ 6,066	4.0%	\$ 9,100	6.0%
Tier I Capital						
(to Average Assets)						
Consolidated	\$ 22,638	9.4%	\$ 9,600	4.0%	\$ 12,000	5.0%
Grayson National Bank	\$ 17,780	7.4%	\$ 9,557	4.0%	\$ 11,946	5.0%

## Notes to Consolidated Financial Statements

### Note 17. Transactions with Related Parties

The Bank has entered into transactions with its directors, significant shareholders and their affiliates (related parties). Such transactions were made in the ordinary course of business on substantially the same terms and conditions, including interest rates and collateral, as those prevailing at the same time for comparable transactions with other customers, and did not, in the opinion of management, involve more than normal credit risk or present other unfavorable features.

Aggregate 2003 and 2002 loan transactions with related parties were as follows:

	<u>2003</u>	<u>2002</u>
<b>Balance, beginning</b>	\$ 2,676,098	\$ 1,439,923
New loans	549,261	2,168,253
Repayments	(1,431,047)	(932,078)
<b>Balance, ending</b>	<u>\$ 1,794,312</u>	<u>\$ 2,676,098</u>

### Note 18. Parent Company Financial Information

Condensed financial information of Grayson Bankshares, Inc. is presented as follows:

#### *Balance Sheets* *December 31, 2003 and 2002*

	<u>2003</u>	<u>2002</u>
<b>Assets</b>		
Cash and due from banks	\$ 2,927,262	\$ 3,919,374
Securities available for sale	1,088,875	980,110
Investment in affiliate bank at equity	20,609,391	18,352,005
Other assets	1,883	4,774
Total assets	<u>\$ 24,627,411</u>	<u>\$ 23,256,263</u>
<b>Liabilities</b>		
Other liabilities	<u>\$ 26,615</u>	<u>\$ 26,746</u>
<b>Stockholders' equity</b>		
Common stock	2,148,710	2,148,710
Surplus	521,625	521,625
Retained earnings	21,587,202	19,967,611
Accumulated other comprehensive income	343,259	591,571
Total stockholders' equity	<u>24,600,796</u>	<u>23,229,517</u>
Total liabilities and stockholders' equity	<u>\$ 24,627,411</u>	<u>\$ 23,256,263</u>

## Notes to Consolidated Financial Statements

### Note 18. Parent Company Financial Information, continued

#### *Statements of Income* *For the years ended December 31, 2003, 2002 and 2001*

	<u>2003</u>	<u>2002</u>	<u>2001</u>
<b>Income:</b>			
Dividends from affiliate bank	\$ 859,484	\$ 790,725	\$ 704,777
Interest on taxable securities	<u>52,281</u>	<u>55,799</u>	<u>54,183</u>
	<u>911,765</u>	<u>846,524</u>	<u>758,960</u>
<b>Expenses:</b>			
Management and professional fees	89,719	88,464	72,039
Other expenses	<u>11,150</u>	<u>8,964</u>	<u>7,286</u>
	<u>100,869</u>	<u>97,428</u>	<u>79,325</u>
Income before tax benefit and equity in undistributed income of affiliate	810,896	749,096	679,635
<b>Federal income tax benefit</b>	<u>16,180</u>	<u>13,814</u>	<u>8,208</u>
Income before equity in undistributed income of affiliate	827,076	762,910	687,843
<b>Equity in undistributed income of affiliate</b>	<u>2,511,483</u>	<u>1,773,549</u>	<u>1,252,057</u>
Net income	<u>\$ 3,338,559</u>	<u>\$ 2,536,459</u>	<u>\$ 1,939,900</u>

#### *Statements of Cash Flows* *For the years ended December 31, 2003, 2002 and 2001*

	<u>2003</u>	<u>2002</u>	<u>2001</u>
<b>Cash flows from operating activities</b>			
Net income	\$ 3,338,559	\$ 2,536,459	\$ 1,939,900
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed income of affiliate	(2,511,483)	(1,773,549)	(1,252,057)
Accretion of discount on securities	-	-	(1,192)
Net (increase) decrease in other assets	(89)	(3,157)	13,611
Net increase (decrease) in other liabilities	<u>(131)</u>	<u>(18,096)</u>	<u>24,980</u>
Net cash provided by operating activities	<u>826,856</u>	<u>741,657</u>	<u>725,242</u>
<b>Cash flows from investing activities</b>			
Purchase of investment securities	(500,000)	(300,000)	(400,000)
Maturities of investment securities	<u>400,000</u>	<u>300,000</u>	<u>250,000</u>
Net cash provided (used) by investing activities	<u>(100,000)</u>	<u>-</u>	<u>(150,000)</u>
<b>Cash flows from financing activities</b>			
Dividends paid	<u>(1,718,968)</u>	<u>(790,725)</u>	<u>(704,777)</u>
Net cash used by financing activities	<u>(1,718,968)</u>	<u>(790,725)</u>	<u>(704,777)</u>
Net increase (decrease) in cash and due from banks	<u>(992,112)</u>	<u>(49,068)</u>	<u>(129,535)</u>
<b>Cash and cash equivalents, beginning</b>	<u>3,919,374</u>	<u>3,968,442</u>	<u>4,097,977</u>
<b>Cash and cash equivalents, ending</b>	<u>\$ 2,927,262</u>	<u>\$ 3,919,374</u>	<u>\$ 3,968,442</u>

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*Management's Discussion and Analysis*

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# Management Discussion and Analysis

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## Management's Discussion and Analysis of Operations

### Overview

Management's Discussion and Analysis is provided to assist in the understanding and evaluation of Grayson Bankshares, Inc.'s financial condition and its results of operations. The following discussion should be read in conjunction with the Company's consolidated financial statements.

Grayson Bankshares, Inc. (the Company) was incorporated as a Virginia corporation on February 3, 1992 to acquire the stock of The Grayson National Bank (the Bank). The Bank was acquired by the Company on July 1, 1992. The Grayson National Bank was founded in 1900 and currently serves Grayson County and surrounding areas through seven banking offices located in the town of Independence, the localities of Elk Creek and Troutdale, the City of Galax and Carroll County, Virginia, and the town of Sparta, North Carolina.

The Bank operates for the primary purpose of meeting the banking needs of individuals and small to medium sized businesses in the Bank's service area, while developing personal, hometown associations with these customers. The Bank offers a wide range of banking services including checking and savings accounts; commercial, installment, mortgage and personal loans; safe deposit boxes; and other associated services. The Bank's primary sources of revenue are interest income from its lending activities, and, to a lesser extent, from its investment portfolio. The Bank also earns fees from lending and deposit activities. The major expenses of the Bank are interest on deposit accounts and general and administrative expenses, such as salaries, occupancy and related expenses.

The earnings position of the Company remains strong. Grayson Bankshares, Inc. experienced net earnings of \$3,338,559 for 2003 compared to \$2,536,459 for 2002, and \$1,939,900 in 2001. Dividends paid to stockholders increased to \$1.00 per share for 2003 compared to \$.46 per share for 2002.

The total assets of Grayson Bankshares, Inc. grew to \$263,864,928 from \$241,282,589, a 9.36% increase, continuing our strategy to grow the Company. Average equity to average assets indicates that the Company has a strong capital position with a ratio of 9.66% during 2003.

### Critical Accounting Policies

The company's financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP). The notes to the audited consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2003 contain a summary of its significant accounting policies. Management believes the Company's policies with respect to the methodology for the determination of the allowance for loan losses, and asset impairment judgments, such as the recoverability of intangible assets, involve a higher degree of complexity and require management to make difficult and subjective judgments that often require assumptions or estimates about highly uncertain matters. Accordingly, management considers the policies related to those areas as critical.

The allowance for loan losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two basic principles of accounting: (i) Statements of Financial Accounting Standards ("SFAS") 5, Accounting for Contingencies, which requires that losses be accrued when they are probable of occurring and estimable, and (ii) SFAS 114, Accounting by Creditors for Impairment of a Loan, which requires that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market, and the loan balance.

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## Management Discussion and Analysis

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The allowance for loan losses has three basic components: (i) the formula allowance, (ii) the specific allowance, and (iii) the unallocated allowance. Each of these components is determined based upon estimates that can and do change when the actual events occur. The formula allowance uses a historical loss view as an indicator of future losses and, as a result, could differ from the loss incurred in the future. However, since this history is updated with the most recent loss information, the errors that might otherwise occur are mitigated. The specific allowance uses various techniques to arrive at an estimate of loss. Historical loss information, expected cash flows and fair market value of collateral are used to estimate these losses. The use of these values is inherently subjective and our actual losses could be greater or less than the estimates. The unallocated allowance captures losses that are attributable to various economic events, industry or geographic sectors whose impact on the portfolio have occurred but have yet to be recognized in either the formula or specific allowance.

Accounting for intangible assets is as prescribed by SFAS 142, Goodwill and Other Intangible Assets. The Company accounts for recognized intangible assets based on their estimated useful lives. Intangible assets with finite useful lives are amortized, while intangible assets with an indefinite useful life are not amortized.

Estimated useful lives of intangible assets are based on an analysis of pertinent factors, including (as applicable):

- the expected use of the asset;
- the expected useful life of another asset or a group of assets to which the useful life of the intangible asset may relate;
- any legal, regulatory, or contractual provision that may limit the useful life;
- any legal, regulatory, or contractual provisions that enable renewal or extension of the asset's legal or contractual life without substantial cost;
- the effects of obsolescence, demand, competition, and other economic factors; and
- the level of maintenance expenditures required to obtain the expected future cash flows from the asset.

Straight-line amortization is used to expense recognized amortizable intangible assets since a method that more closely reflects the pattern in which the economic benefits of the intangible assets are consumed cannot reliably be determined. Intangible assets are not written off in the period of acquisition unless they become impaired during that period.

The Company evaluates the remaining useful life of each intangible asset that is being amortized each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization. If the estimate of the intangible asset's remaining useful life is changed, the remaining carrying amount of the intangible asset shall be amortized prospectively of that revised remaining useful life.

If an intangible asset that is being amortized is subsequently determined to have an indefinite useful life, the asset will be tested for impairment. That intangible asset will no longer be amortized and will be accounted for in the same manner as intangible assets that are not subject to amortization.

Intangible assets that are not subject to amortization are reviewed for impairment in accordance with SFAS 121 and tested annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test consists of a comparison of the fair value of the intangible asset with its carrying amount. If the carrying amount of the intangible asset exceeds its fair value, an impairment loss is recognized in an amount equal to that excess. After an impairment loss is recognized, the adjusted carrying amount of the intangible assets becomes its new accounting basis. Subsequent reversal of a previously recognized impairment loss is not allowed.

## Management Discussion and Analysis

**Table 1. Net Interest Income and Average Balances (dollars in thousands)**

	2003			2002			2001		
	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost
<i>Interest earning assets:</i>									
Federal funds sold	\$ 23,878	\$ 246	1.03%	\$ 15,322	\$ 239	1.56%	\$ 9,246	\$ 336	3.63%
Investment securities	45,015	2,000	4.44%	41,901	2,242	5.35%	29,472	1,621	5.50%
Loans	165,058	11,596	7.03%	150,992	11,799	7.81%	139,486	11,760	8.43%
Total	233,951	13,842		208,215	14,280		178,204	13,717	
Yield on average interest-earning assets			5.92%			6.86%			7.70%
<i>Non interest-earning assets:</i>									
Cash and due from banks	7,955			8,233			7,082		
Premises and equipment	5,283			3,392			2,809		
Interest receivable and other	7,348			6,667			2,819		
Allowance for loan losses	(2,245)			(1,941)			(1,798)		
Unrealized gain/(loss) on securities	856			542			272		
Total	19,197			16,893			11,184		
Total assets	\$ 253,148			\$ 225,108			\$ 189,388		
<i>Interest-bearing liabilities:</i>									
Demand deposits	\$ 18,277	221	1.21%	\$ 16,950	338	1.99%	\$ 14,189	351	2.47%
Savings deposits	42,380	717	1.69%	35,411	857	2.42%	29,786	921	3.09%
Time deposits	130,303	4,185	3.21%	118,820	5,003	4.21%	104,685	5,932	5.67%
Borrowings	12,548	514	4.09%	9,556	442	4.63%	-	-	0.00%
Total	203,508	5,637		180,737	6,640		148,660	7,204	
Cost on average interest-bearing liabilities			2.77%			3.67%			4.85%
<i>Non interest-bearing liabilities:</i>									
Demand deposits	23,671			20,644			18,721		
Interest payable and other	1,522			1,484			1,462		
Total	25,193			22,128			20,183		
Total liabilities	228,701			202,865			168,843		
<i>Stockholder's equity:</i>	24,447			22,243			20,545		
Total liabilities and stockholder's equity	\$ 253,148			\$ 225,108			\$ 189,388		
Net interest income		\$ 8,205			\$ 7,640			\$ 6,513	
Net yield on interest-earning assets			3.66%			3.67%			3.65%



## Management Discussion and Analysis

**Table 2. Rate/Volume Variance Analysis (thousands)**

	2003 Compared to 2002			2002 Compared to 2001		
	Interest Income/ Expense Variance	Variance Attributable To Rate      Volume		Interest Income/ Expense Variance	Variance Attributable To Rate      Volume	
<i>Interest-earning assets:</i>						
Federal funds sold	\$ 7	\$ (98)	\$ 105	\$ (97)	\$ (249)	\$ 152
Investment securities	(242)	(400)	158	621	(45)	666
Loans	(203)	(1,235)	1,032	39	(898)	937
Total	(438)	(1,733)	1,295	563	(1,192)	1,755
<i>Interest-bearing liabilities:</i>						
Demand deposits	(117)	(140)	23	(13)	(75)	62
Savings deposits	(140)	(289)	149	(64)	(220)	156
Time deposits	(818)	(1,269)	451	(929)	(1,663)	734
Long-term borrowings	72	51	21	442	-	442
Total	(1,003)	(1,647)	644	(564)	(1,958)	1,394
<b>Net interest income</b>	<b>\$ 565</b>	<b>\$ (86)</b>	<b>\$ 651</b>	<b>\$ 1,127</b>	<b>\$ 766</b>	<b>\$ 361</b>

### Net Interest Income

Net interest income, the principal source of Company earnings, is the amount of income generated by earning assets (primarily loans and investment securities) less the interest expense incurred on interest-bearing liabilities (primarily deposits used to fund earning assets). Table 1 summarizes the major components of net interest income for the past three years and also provides yields and average balances.

Total interest income in 2003 decreased by 3.07% to \$13.84 million from \$14.28 million in 2002 after an increase from \$13.72 in 2001. The decrease in total interest income in 2003 was due to a 94 basis point decrease in yield on interest-earning assets which offset the \$25.74 million increase in the average balance of interest-earning assets. The increase in total interest income in 2002 was the result of a \$30.01 million dollar increase in average interest-earning assets, which was partially offset by an 84 basis point decrease in yields on interest-earning assets. Total interest expense decreased by approximately \$1,003,000 in 2003 and \$564,000 in 2002. The decreases each year were the result of decreases in the average rate paid for interest-bearing liabilities of 0.90% and 1.18% for 2003 and 2002 respectively. The effects of changes in volumes and rates on net interest income in 2003 compared to 2002, and 2002 compared to 2001 are shown in Table 2.

Despite the volatility in interest rates in recent years, net yield on interest-earning assets has remained relatively stable with an increase of just 2 basis points from 2001 to 2002 and a decrease of 1 basis point from 2002 to 2003.

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## Management Discussion and Analysis

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### Provision for Credit Losses

The allowance for credit losses is established to provide for expected losses in the Bank's loan portfolio. Loan losses and recoveries are charged or credited directly to the allowance. Management determines the provision for credit losses required to maintain an allowance adequate to provide for probable losses. The factors considered in making this decision are the collectibility of past due loans, volume of new loans, composition of the loan portfolio, and general economic outlook.

At the end of 2003, the loan loss reserve was \$2,395,387 compared to \$2,189,028 in 2002 and \$1,821,966 in 2001. The Bank's allowance for loan losses, as a percentage of total loans, at the end of 2003 was 1.34%, compared to 1.40% in 2002, and 1.28% in 2001.

Additional information is contained in Tables 12 and 13, and is discussed in Nonperforming and Problem Assets.

### Other Income

Noninterest income consists of revenues generated from a broad range of financial services and activities. The majority of noninterest income is traditionally a result of service charges on deposit accounts including charges for insufficient funds checks and fees charged for nondeposit services. Noninterest income increased by \$1,640,347, or 160.61%, to \$2,661,648 in 2003 from \$1,021,301 in 2002. Noninterest income in 2001 totaled \$589,028. The increase from 2002 to 2003 was primarily due to gains on the sale of securities, which totaled \$920 thousand, and gains on the termination of an interest rate swap of approximately \$522 thousand. Approximately \$866 thousand of the securities gains came as a result of the restructuring of a leveraging strategy that the bank implemented in 2002. These gains, as well as the gains from the interest rate swap, are non-recurring in nature, and as such, management does not anticipate similar gains in the future. The primary sources of noninterest income for the past three years are summarized in Table 3.

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**Table 3. Sources of Noninterest Income (thousands)**

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	<u>2003</u>	<u>2002</u>	<u>2001</u>
Service charges on deposit accounts	\$ 429	\$ 355	\$ 333
Other service charges and fees	176	171	132
Increase in cash value of life insurance	237	225	-
Mortgage origination fees	190	113	-
Insurance commissions	24	27	36
Safe deposit box rental	35	30	30
Gain on the sale of securities	920	4	6
Gain on interest rate swap	522	-	-
Other income	129	96	52
Total noninterest income	<u>\$ 2,662</u>	<u>\$ 1,021</u>	<u>\$ 589</u>

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## Management Discussion and Analysis

### Other Expense

The major components of noninterest expense for the past three years are illustrated at Table 4.

Total noninterest expense increased by \$1,092,412 or 23.14% to \$5,812,589 in 2003. This increase was primarily due to increases in personnel expense, occupancy, equipment and other expenses, resulting from the construction of two new branch banking facilities. One facility was constructed in order to relocate an existing branch while another established a new branch. Noninterest expense increased by \$627,775 from 2001 to 2002. The majority of the increase in 2002 was attributable to increases in personnel expense resulting from staff additions and increases in medical and pension benefit costs.

**Table 4. Sources of Noninterest Expense (thousands)**

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Salaries & wages	\$ 2,603.3	\$ 2,169.5	\$ 1,878.0
Employee benefits	<u>1,073.0</u>	<u>816.1</u>	<u>678.4</u>
Total personnel expense	3,676.3	2,985.6	2,556.4
Director fees	106.7	73.8	47.8
Occupancy expense	169.9	127.2	121.0
Computer charges	123.7	83.5	51.8
Other equipment expense	501.7	391.4	369.9
FDIC/OCC assessments	107.5	98.6	87.1
Insurance	48.3	52.2	47.4
Professional fees	48.5	48.4	38.8
Advertising	152.9	142.8	118.9
Postage and freight	133.8	133.8	173.0
Supplies	167.3	124.8	122.0
Franchise tax	165.0	146.5	134.5
Telephone	94.6	76.4	58.6
Travel, dues & meetings	81.5	74.0	44.5
Other expense	<u>234.9</u>	<u>161.2</u>	<u>120.7</u>
Total noninterest expense	<u>5,812.6</u>	<u>4,720.2</u>	<u>4,092.4</u>

The overhead efficiency ratio of noninterest expense to adjusted total revenue (net interest income plus noninterest income) was 53.5% in 2003, 54.5% in 2002 and 57.6% in 2001.

### Income Taxes

Income tax expense is based on amounts reported in the statements of income (after adjustments for non-taxable income and non-deductible expenses) and consists of taxes currently due plus deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. The deferred tax assets and liabilities represent the future Federal income tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled.

## Management Discussion and Analysis

Income tax expense (substantially all Federal) was \$1,305,535 in 2003, \$964,103 in 2002 and \$789,551 in 2001 resulting in effective tax rates of 28.1%, 27.5% and 28.9% respectively. The increase in the effective tax rate for 2003 was due to a slight decrease in the percentage of tax-exempt income.

The Bank's deferred income tax benefits and liabilities result primarily from temporary differences (discussed above) in the provisions for credit losses, valuation reserves, depreciation, deferred compensation, deferred income, pension expense and investment security discount accretion.

Net deferred tax benefits of \$698,513 and \$530,015 are included in other assets at December 31, 2003 and 2002 respectively. At December 31, 2003, net deferred tax benefits included \$176,830 of deferred tax liabilities applicable to unrealized depreciation on investment securities available for sale. Accordingly, this amount was not charged to income but recorded directly to the related stockholders' equity account.

### Analysis of Financial Condition

Average earning assets increased 12.36% from December 31, 2002 to December 31, 2003. Total earning assets represented 92.42% of total average assets in 2003 and 92.50% in 2002. The mix of average earning assets remained relatively unchanged from 2002 to 2003 as deposit growth funded increases in all interest-bearing asset categories.

**Table 5. Average Asset Mix (dollars in thousands)**

	2003		2002	
	Average Balance	%	Average Balance	%
<b>Earning assets:</b>				
Loans	\$ 165,058	65.20%	\$ 150,992	67.08%
Investment securities	45,015	17.78%	41,901	18.61%
Federal funds sold	23,878	9.44%	15,322	6.81%
Deposits in other banks	-	0.00%	-	0.00%
Total earning assets	233,951	92.42%	208,215	92.50%
<b>Nonearning assets:</b>				
Cash and due from banks	7,955	3.14%	8,233	3.65%
Premises and equipment	5,283	2.09%	3,392	1.51%
Other assets	7,348	2.90%	6,667	2.96%
Allowance for loan losses	(2,245)	-0.89%	(1,941)	-0.86%
Unrealized gain/(loss) on securities	856	0.34%	542	0.24%
Total nonearning assets	19,197	7.58%	16,893	7.50%
Total assets	\$ 253,148	100.00%	\$ 225,108	100.00%

Average loans for 2003 represented 65.20% of total average assets compared to 67.08% in 2002. Average federal funds sold increased from 6.81% to 9.44% of total average assets while average investment securities decreased from 18.61% to 17.78% of total average assets over the same time period. The average balance of premises and equipment increased in 2003 commensurate with the construction of two branch banking facilities.

## Management Discussion and Analysis

### Loans

Average loans totaled \$165.1 million over the year ended December 31, 2003. This represents an increase of 9.3% over the average of \$151.0 million for 2002. Average loans increased by 8.2% from 2001 to 2002.

The loan portfolio is dominated by real estate and commercial. These loans accounted for 90.3% of the total loan portfolio at December 31, 2003. This is up from the 86.9% that the two categories maintained at December 31, 2002. The amount of loans outstanding by type at December 31, 2003 and December 31, 2002 and the maturity distribution for variable and fixed rate loans as of December 31, 2003 are presented in Tables 6 & 7 respectively.

**Table 6. Loan Portfolio Summary (dollars in thousands)**

	December 31, 2003		December 31, 2002	
	Amount	%	Amount	%
Construction and development	\$ 14,530	8.14%	\$ 6,040	3.86%
Residential, 1-4 families	83,824	46.95%	73,135	46.77%
Residential, 5 or more families	321	0.18%	140	0.09%
Farmland	15,640	8.76%	7,546	4.83%
Nonfarm, nonresidential	31,902	17.86%	35,014	22.39%
Total real estate	146,217	81.89%	121,875	77.94%
Agricultural	3,152	1.77%	4,997	3.20%
Commercial	15,093	8.45%	13,960	8.93%
Consumer	13,040	7.30%	14,753	9.43%
Other	1,048	0.59%	794	0.50%
Total	<u>\$ 178,550</u>	<u>100.00%</u>	<u>\$ 156,379</u>	<u>100.00%</u>

## Management Discussion and Analysis

**Table 7. Maturity Schedule of Loans (dollars in thousands)**

	Real Estate	Agricultural and Commercial	Consumer and Other	Total	
				Amount	%
<b>Fixed rate loans:</b>					
Three months or less	\$ 10,603	\$ 2,920	\$ 1,646	\$ 15,169	8.50%
Over three to twelve months	26,409	2,179	2,831	31,419	17.60%
Over one year to five years	32,418	1,599	8,785	42,802	23.97%
Over five years	20,602	14	351	20,967	11.74%
Total fixed rate loans	\$ 90,032	\$ 6,712	\$ 13,613	\$ 110,357	61.81%
<b>Variable rate loans:</b>					
Three months or less	\$ 14,039	\$ 6,055	\$ 269	\$ 20,363	11.40%
Over three to twelve months	2,226	522	21	2,769	1.55%
Over one year to five years	16,164	956	185	17,305	9.69%
Over five years	23,756	4,000	-	27,756	15.55%
Total variable rate loans	\$ 56,185	\$ 11,533	\$ 475	\$ 68,193	38.19%
<b>Total loans:</b>					
Three months or less	\$ 24,642	\$ 8,975	\$ 1,915	\$ 35,532	19.90%
Over three to twelve months	28,635	2,701	2,852	34,188	19.15%
Over one year to five years	48,582	2,555	8,970	60,107	33.66%
Over five years	44,358	4,014	351	48,723	27.29%
Total loans	\$ 146,217	\$ 18,245	\$ 14,088	\$ 178,550	100.00%

Interest rates charged on loans vary with the degree of risk, maturity and amount of the loan. Competitive pressures, money market rates, availability of funds, and government regulation also influence interest rates. On average, loans yielded 7.03% in 2003 compared to an average yield of 7.81% in 2002.

### Investment Securities

The Bank uses its investment portfolio to provide liquidity for unexpected deposit decreases or loan generation, to meet the Bank's interest rate sensitivity goals, and to generate income.

Management of the investment portfolio has always been conservative with the majority of investments taking the form of purchases of U.S. Treasury, U.S. Government Agencies and State and Municipal bonds, as well as investment grade corporate bond issues. Management views the investment portfolio as a source of income, and purchases securities with the intent of retaining them until maturity. However, adjustments are necessary in the portfolio to provide an adequate source of liquidity which can be used to meet funding requirements for loan demand and deposit fluctuations and to control interest rate risk. Therefore, from time to time, management may sell certain securities prior to their maturity. Table 8 presents the investment portfolio at the end of 2003 by major types of investments and contractual maturity ranges. Investment securities in Table 8 may have repricing or call options that are earlier than the contractual maturity date.

Total investment securities increased by approximately \$1.17 million from December 31, 2002 to December 31, 2003 as deposit growth, in excess of loan demand, funded the purchase of additional investment securities. The average yield of the investment portfolio decreased to 4.44% for the year ended December 31, 2003 compared to 5.35% for 2002.

## Management Discussion and Analysis

**Table 8. Investment Securities - Maturity/Yield Schedule (dollars in thousands)**

	In One Year or Less	After One Through Five Years	After Five Through Ten Years	After Ten Years	Total	Market Value
<b>Investment Securities:</b>						
U.S. Government agencies	\$ 754	\$ 3,959	\$ 2,492	\$ 6,952	\$ 14,157	\$ 13,972
Mortgage-backed securities	625	1,995	194	-	2,814	2,888
State and municipal securities	2,963	5,850	6,182	808	15,803	16,211
Corporate securities	5,250	4,156	500	2,000	11,906	12,165
Total	<u>\$ 9,592</u>	<u>\$ 15,960</u>	<u>\$ 9,368</u>	<u>\$ 9,760</u>	<u>\$ 44,680</u>	<u>\$ 45,236</u>
<b>Weighted average yields:</b>						
U.S. Government agencies	4.18%	4.19%	3.61%	4.00%	3.99%	
Mortgage-backed securities	3.77%	5.11%	6.61%	-	4.92%	
State and municipal securities	6.31%	5.54%	5.39%	5.18%	5.61%	
Corporate securities	2.93%	6.34%	3.00%	3.35%	4.18%	
Total	<u>4.13%</u>	<u>5.34%</u>	<u>4.88%</u>	<u>4.04%</u>	<u>4.69%</u>	

### Deposits

The Bank relies on deposits generated in its market area to provide the majority of funds needed to support lending activities and for investments in liquid assets. More specifically, core deposits (total deposits less certificates of deposit in denominations of \$100,000 or more) are the primary funding source. The Bank's balance sheet growth is largely determined by the availability of deposits in its markets, the cost of attracting the deposits, and the prospects of profitably utilizing the available deposits by increasing the loan or investment portfolios. Market conditions have resulted in depositors shopping for deposit rates more than in the past. An increased customer awareness of interest rates adds to the importance of rate management. The Bank's management must continuously monitor market pricing, competitor's rates, and the internal interest rate spreads to maintain the Bank's growth and profitability. The Bank attempts to structure rates so as to promote deposit and asset growth while at the same time increasing overall profitability of the Bank.

Average total deposits for the year ended December 31, 2003 amounted to \$214.6 million, which was an increase of \$22.8 million, or 11.9% over 2002. Average core deposits totaled \$178.8 million in 2003 representing a 12.3% increase over the \$159.2 million in 2002. The percentage of the Bank's average deposits that are interest-bearing decreased from 89.2% in 2002 to 89.0% in 2003. Average demand deposits, which earn no interest, increased 14.7% from \$20.6 million in 2002 to \$23.7 million in 2003. Average deposits for the periods ended December 31, 2003 and December 31, 2002 are summarized in Table 9.

## Management Discussion and Analysis

**Table 9. Deposit Mix (dollars in thousands)**

	2003			2002		
	Average Balance	% of Total Deposits	Average Rate Paid	Average Balance	% of Total Deposits	Average Rate Paid
Interest-bearing deposits:						
NOW accounts	\$ 18,277	8.5%	1.21%	\$ 16,950	8.8%	1.99%
Money Market	9,101	4.2%	1.58%	6,776	3.5%	2.37%
Savings	33,279	15.5%	1.72%	28,635	14.9%	2.42%
Small denomination certificates	94,497	44.1%	3.23%	86,169	44.9%	4.22%
Large denomination certificates	35,806	16.7%	3.18%	32,651	17.1%	4.18%
Total interest-bearing deposits	190,960	89.0%	2.68%	171,181	89.2%	3.62%
Noninterest-bearing deposits	23,671	11.0%	0.00%	20,644	10.8%	0.00%
Total deposits	<u>\$ 214,631</u>	<u>100.0%</u>	<u>2.39%</u>	<u>\$ 191,825</u>	<u>100.0%</u>	<u>3.23%</u>

The average balance of certificates of deposit issued in denominations \$100,000 or more increased by \$3.2 million, or 9.7%, for the year ended December 31, 2003. The strategy of management has been to support loan and investment growth with core deposits and not to aggressively solicit the more volatile, large denomination certificates of deposit. Table 10 provides maturity information relating to certificates of deposit of \$100,000 or more at December 31, 2003.

**Table 10. Large Time Deposit Maturities (thousands)**

**Analysis of time deposits of \$100,000 or more at December 31, 2003:**

Remaining maturity of three months or less	\$ 7,828
Remaining maturity over three through twelve months	21,636
Remaining maturity over one through five years	5,232
Remaining maturity over five years	-
Total time deposits of \$100,000 or more	<u>\$ 34,696</u>



## Management Discussion and Analysis

### Equity

Stockholders' equity amounted to \$24.6 million at December 31, 2003, a 5.9% increase over the 2002 year-end total of \$23.2 million. The increase resulted from earnings of approximately \$3.3 million, less dividends paid and a change in unrealized depreciation of investment securities classified as available for sale. The Company paid dividends of \$1.00, \$0.46 and \$0.41 per share in 2003, 2002 and 2001, respectively. The Board of Directors voted to declare a special dividend of \$.50 in 2003 in light of the non-recurring gains described under the caption "other income". Management does not expect this special dividend to be recurring.

Regulatory guidelines relating to capital adequacy provide minimum risk-based ratios which assess capital adequacy while encompassing all credit risks, including those related to off-balance sheet activities. Capital ratios under these guidelines are computed by weighing the relative risk of each asset category to derive risk-adjusted assets. The risk-based capital guidelines require minimum ratios of core (Tier 1) capital (common stockholders' equity) to risk-weighted assets of 4.0% and total regulatory capital (core capital plus allowance for loan losses up to 1.25% of risk-weighted assets) to risk-weighted assets of 8.0%. As of December 31, 2003 the Bank has a ratio of Tier 1 capital to risk-weighted assets of 11.8% and a ratio of total capital to risk-weighted assets of 13.0%.

**Table 11. Bank's Year-end Risk-Based Capital (dollars in thousands)**

Tier 1 capital	\$ 20,292	\$ 17,780
Qualifying allowance for loan losses (limited to 1.25% of risk-weighted assets)	2,159	1,899
Total regulatory capital	<u>\$ 22,451</u>	<u>\$ 19,679</u>
Total risk-weighted assets	<u>\$ 172,500</u>	<u>\$ 151,660</u>
Tier 1 capital as a percentage of risk-weighted assets	11.8%	11.7%
Total regulatory capital as a percentage of risk-weighted assets	13.0%	13.0%
Leverage ratio*	7.8%	7.4%

\*Tier 1 capital divided by average total assets for  
the quarter ended December 31 of each year.

In addition, a minimum leverage ratio of Tier 1 capital to average total assets for the previous quarter is required by federal bank regulators, ranging from 3% to 5%, subject to the regulator's evaluation of the Bank's overall safety and soundness. As of December 31, 2003, the Bank had a ratio of year-end Tier 1 capital to average total assets for the fourth quarter of 2003 of 7.8%. Table 11 sets forth summary information with respect to the Bank's capital ratios at December 31, 2003. All capital ratio levels indicate that the Bank is well capitalized.

At December 31, 2003 the Company had 1,718,968 shares of common stock outstanding, which were held by approximately 650 shareholders of record.

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## Management Discussion and Analysis

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### Nonperforming and Problem Assets

Certain credit risks are inherent in making loans, particularly commercial and consumer loans. Management prudently assesses these risks and attempts to manage them effectively. The Bank attempts to use shorter-term loans and, although a portion of the loans have been made based upon the value of collateral, the underwriting decision is generally based on the cash flow of the borrower as the source of repayment rather than the value of the collateral.

The Bank also attempts to reduce repayment risk by adhering to internal credit policies and procedures. These policies and procedures include officer and customer limits, periodic loan documentation review and follow up on exceptions to credit policies

Nonperforming assets at December 31, 2003 and 2002 are analyzed in Table 12.

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**Table 12. Nonperforming Assets (dollars in thousands)**

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	December 31, 2003		December 31, 2002	
	Amount	%of Loans	Amount	%of Loans
Nonaccrual loans	\$ 1,435	0.8%	\$ 649	0.4%
Restructured loans	484	0.3%	384	0.2%
Loans past due 90 days or more	2,119	1.2%	1,883	1.2%
Total nonperforming assets	<u>\$ 4,038</u>	<u>2.3%</u>	<u>\$ 2,916</u>	<u>1.8%</u>

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Total nonperforming assets were 2.3% and 1.8% of total outstanding loans as of December 31, 2003 and 2002 respectively.

The allowance for loan losses is maintained at a level adequate to absorb potential losses. Some of the factors which management considers in determining the appropriate level of the allowance for loan losses are: past loss experience, an evaluation of the current loan portfolio, identified loan problems, the loan volume outstanding, the present and expected economic conditions in general, and in particular, how such conditions relate to the market area that the Bank serves. Bank regulators also periodically review the Bank's loans and other assets to assess their quality. Loans deemed uncollectible are charged to the allowance. Provisions for loan losses and recoveries on loans previously charged off are added to the allowance. The accrual of interest on a loan is discontinued when, in the opinion of management, there is an indication that the borrower may be unable to meet payments as they become due.

The provision for loan losses, net charge-offs and the activity in the allowance for loan losses is detailed in Table 13. The allocation of the reserve for loan losses is detailed in Table 14. The methodology for allocating the reserve for loan losses was modified in 2002 based on historical charge-off percentages. The effect of the modification was to allocate a greater portion of the reserve to the areas of the loan portfolio which have presented more historical credit risk.

## Management Discussion and Analysis

**Table 13. Loan Losses (thousands)**

	2003	2002	2001
Allowance for loan losses, beginning	\$ 2,189,028	\$ 1,821,966	\$ 1,760,999
Provision for loan losses, added	410,000	441,000	280,000
Charge-offs:			
Real estate	(26,195)	(100,000)	(124,547)
Commercial and agricultural	(86,627)	(42,207)	(44,274)
Consumer and other	(194,601)	(121,796)	(139,071)
Recoveries:			
Real estate	5,308	26,477	24,845
Commercial and agricultural	52,056	137,141	25,132
Consumer and other	46,418	26,447	38,882
Net charge-offs	(203,641)	(73,938)	(219,033)
Allowance for loan losses, ending	<u>\$ 2,395,387</u>	<u>\$ 2,189,028</u>	<u>\$ 1,821,966</u>

**Table 14. Allocation of the Reserve for Loan Losses (thousands)**

	2003		2002	
	Amount	% of Loans to Total Loans	Amount	% of Loans to Total Loans
Balance at the end of the period applicable to:				
Commercial and agricultural	\$ 773	10.22%	\$ 977	12.13%
Real estate - construction	-	8.14%	-	3.86%
Real estate - mortgage	559	73.75%	495	74.08%
Consumer and other	1,063	7.89%	717	9.93%
Total	<u>\$ 2,395</u>	<u>100.00%</u>	<u>\$ 2,189</u>	<u>100.00%</u>

### Quantitative and Qualitative Disclosure about Market Risk

The principal goals of the Bank's asset and liability management strategy are the maintenance of adequate liquidity and the management of interest rate risk. Liquidity is the ability to convert assets to cash to fund depositors' withdrawals or borrowers' loans without significant loss. Interest rate risk management balances the effects of interest rate changes on assets that earn interest or liabilities on which interest is paid, to protect the Bank from wide fluctuations in its net interest income which could result from interest rate changes.

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## Management Discussion and Analysis

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Management must insure that adequate funds are available at all times to meet the needs of its customers. On the asset side of the balance sheet, maturing investments, loan payments, maturing loans, federal funds sold, and unpledged investment securities are principal sources of liquidity. On the liability side of the balance sheet, liquidity sources include core deposits, the ability to increase large denomination certificates, federal fund lines from correspondent banks, borrowings from the Federal Home Loan Bank, as well as the ability to generate funds through the issuance of long-term debt and equity.

The liquidity ratio (the level of liquid assets divided by total deposits plus short-term liabilities) was 28.9% at December 31, 2003 compared to 33.3% at December 31, 2002. These ratios are considered to be adequate by management.

Interest rate risk is the effect that changes in interest rates would have on interest income and interest expense as interest-sensitive assets and interest-sensitive liabilities either reprice or mature. Management attempts to maintain the portfolios of interest-earning assets and interest-bearing liabilities with maturities or repricing opportunities at levels that will afford protection from erosion of net interest margin, to the extent practical, from changes in interest rates. Table 15 shows the sensitivity of the Bank's balance sheet on December 31, 2003. This table reflects the sensitivity of the balance sheet as of that specific date and is not necessarily indicative of the position on other dates. At December 31, 2003, the Bank appeared to be cumulatively asset-sensitive (interest-earning assets subject to interest rate changes exceeding interest-bearing liabilities subject to changes in interest rates). However, in the one year window liabilities subject to change in interest rates exceed assets subject to interest rate changes (non asset-sensitive).

Matching sensitive positions alone does not ensure the Bank has no interest rate risk. The repricing characteristics of assets are different from the repricing characteristics of funding sources. Thus, net interest income can be impacted by changes in interest rates even if the repricing opportunities of assets and liabilities are perfectly matched.

## Management Discussion and Analysis

**Table 15. Interest Rate Sensitivity (dollars in thousands)**

	December 31, 2003				
	Maturities/Repricing				
	1 to 3 Months	4 to 12 Months	13 to 60 Months	Over 60 Months	Total
<b>Interest-Earning Assets:</b>					
Federal funds sold	\$ 15,306	\$ -	\$ -	\$ -	\$ 15,036
Investments	2,756	6,782	17,200	17,942	44,680
Loans	51,625	37,667	61,294	27,964	178,550
Total	<u>\$ 69,687</u>	<u>\$ 44,449</u>	<u>\$ 78,494</u>	<u>\$ 45,906</u>	<u>\$ 238,266</u>
<b>Interest-Bearing Liabilities:</b>					
NOW accounts	\$ 19,360	\$ -	\$ -	\$ -	\$ 19,360
Money market	14,980	-	-	-	14,980
Savings	38,435	-	-	-	38,435
Certificates of deposit	27,712	66,296	34,728	-	128,736
Total	<u>\$ 100,487</u>	<u>\$ 66,296</u>	<u>\$ 34,728</u>	<u>\$ -</u>	<u>\$ 201,511</u>
Interest sensitivity gap	\$ (30,800)	\$ (21,847)	\$ 43,766	\$ 45,906	\$ 37,025
Cumulative interest sensitivity gap	\$ (30,800)	\$ (52,647)	\$ (8,881)	\$ 37,025	\$ 37,025
Ratio of sensitivity gap to total earning assets	-12.9%	-9.2%	18.4%	19.2%	15.5%
Cumulative ratio of sensitivity gap to total earning assets	-12.9%	-22.1%	-3.7%	15.5%	15.5%

The Company uses a number of tools to manage its interest rate risk, including simulating net interest income under various scenarios, monitoring the present value change in equity under the same scenarios, and monitoring the difference or gap between rate sensitive assets and rate sensitive liabilities over various time periods (as displayed in Table 15).

The earnings simulation model forecasts annual net income under a variety of scenarios that incorporate changes in the absolute level of interest rates, changes in the shape of the yield curve and changes in interest rate relationships. Management evaluates the effect on net interest income and present value equity from gradual changes in rates of up to 300 basis points up or down over a 12-month period. Table 16 presents the Bank's forecasts for changes in net income and market value of equity as of December 31, 2003.

## Management Discussion and Analysis

**Table 16. Interest Rate Risk (dollars in thousands)**

Rate Shocked Net Interest Income and Market Value of Equity							
Rate Change	-300bp	-200bp	-100bp	0bp	+100bp	+200bp	+300bp
<b>Net Interest Income:</b>							
Net Interest Income	\$ 8,439	\$ 8,640	\$ 8,841	\$ 9,041	\$ 9,248	\$ 9,475	\$ 9,551
Change	\$ (602)	\$ (401)	\$ (200)	\$ -	\$ 207	\$ 434	\$ 510
Change percentage	-6.65%	-4.43%	-2.21%	0.00%	2.30%	4.81%	5.64%
<b>Market Value of Equity</b>							
	\$ 33,641	\$ 27,946	\$ 23,063	\$ 19,504	\$ 16,107	\$ 12,839	\$ 9,687

### Impact of Inflation and Changing Prices

The consolidated financial statements and the accompanying notes presented elsewhere in this document have been prepared in accordance with generally accepted accounting principles which require the measurement of financial position and operating results in terms of historical dollars without considering the change in the relative purchasing power of money over time and due to inflation. Unlike most industrial companies, virtually all the assets and liabilities are monetary in nature. The impact of inflation is reflected in the increased cost of operations. As a result, interest rates have a greater impact on performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

**Table 17. Key Financial Ratios**

	2003	2002	2001
Return on average assets	1.32%	1.13%	1.02%
Return on average equity	13.66%	11.40%	9.44%
Dividend payout ratio	51.49%	31.17%	36.33%
Average equity to average assets	9.66%	9.88%	10.85%

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## **Staff**

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### ***Loan Department and Mortgage Origination***

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Sarah Cox

Judy Carpenter

Pat Sage

Robin Fincher

### ***Tellers***

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Brenda Brown

Rebecca Reedy

Deranda Roop

Ann Shuler

Nancy Burkett

Dorothy Galyean

Barbara McBride

Terry Davis

Hilda Anderson

Mary Jane Leonard

Erin Cox

Donna Austin

Teresa Edwards

Christine Saltz

Angela Lawrence

Sherita Sizemore

Lynn Cox

Rose Gonzalez

Donna Anders

Jeanne' Funk

Anita McGrady

Phyllis Fender

Sheila Taylor

Lisa Buchanan

Pat Richardson

Sherry Key

LeAngela Haynes

Kristi Nichols

Mary Blevins

Peggy Spencer

Tanisha Lawson

Tammy Herrington

Cindy Seldon

Joyce Reavis

### ***Bookkeeping & Proof***

---

Becky Callahan

Ann Graham

Loretta Painter

Rhonda Lineberry

Janna Billings

Rhonda James

Dorothy Hash

Elaine Roberts

Lorie Casino

Nancy Hale

Sparkle Holder

### ***Secretaries and Customer Service Personnel***

---

Judy Cummings

Glenda Ward

Carol Moxley

Sue Faddis

Pam Neill

Cindy Teaster

### ***Receptionists and Office Services***

---

Elisa Blevins

Brenda Thompson

Greg Reedy

Faye Dotson

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## Board of Directors and Officers

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### Board of Directors

Julian L. Givens .....	Physician
Jacky K. Anderson .....	Grayson Bankshares, Inc. and Grayson National Bank
Jack E. Guynn, Jr. ....	Guynn Enterprises, Inc.
Fred B. Jones .....	Farmer
Jean W. Lindsey .....	Walter's Drug, Inc.
Charles T. Sturgill .....	Grayson County Clerk of Court
Dennis B. Gambill .....	Grayson Bankshares, Inc. and Grayson National Bank
Carl J. Richardson .....	Retired, Grayson National Bank
J. David Vaughan .....	Vaughan Furniture
Thomas E. Jackson, Jr. ....	Attorney-at-Law

### Grayson Bankshares Officers

Julian L. Givens .....	Chairman of the Board
Jacky K. Anderson .....	President and CEO
Dennis B. Gambill .....	Vice President
Brenda C. Smith .....	Secretary
Blake M. Edwards .....	Chief Financial Officer

### Grayson National Bank Officers

Julian L. Givens .....	Chairman of the Board
Charles T. Sturgill .....	Vice Chairman
Jacky K. Anderson .....	President and CEO
Dennis B. Gambill .....	Executive Vice President
Curtis A. Jennings .....	Senior Vice President
Brenda C. Smith .....	Senior Vice President
Blake M. Edwards .....	Chief Financial Officer
Peggy H. Haga .....	Vice President-Customer Service Rep
Ann Graham .....	Operations Manager
Darlene B. Hensdell .....	Assistant VP-Customer Service Rep
Larry D. Osborne .....	Assistant VP-Branch Manager of East Independence Office
Jerry D. Wright .....	Vice President
Ronald P. Porter .....	Vice President-Branch Manager of Galax Office
Sharon Caudill .....	Assistant Branch Manager of Galax Office-Loan Officer
Brenda C. Parks .....	Branch Manager of Troutdale Office
Carol Lee Sutherland .....	Branch Manager of Elk Creek Office
Linda B. Eller .....	Executive Secretary/Administrative Assistant
Rodney R. Halsey .....	Assistant VP-Loan Officer-EDP
Tom Gentry .....	Commercial Loan Officer
G. Kevin Weatherman .....	Assistant Branch Manager of Carroll Office-Loan Officer
Carolyn A. Cornett .....	Vice President-Auditor/Compliance Officer
Lori Vaught .....	Credit Administrator
Robert T. Fender .....	Loan Review Officer
Deborah McCormick .....	Collections Officer
Marcia T. Sutherland .....	Loan Officer
Charles Smith .....	Loan Officer/Security Officer
Greg L. Bare .....	Branch Manager of Sparta Office
Ruby Stuart .....	Branch Manager of Carroll Office
Sheila G. Douglas .....	Assistant Branch Manager of Sparta Office-Loan Officer
Delma C. Smith .....	Assistant VP-Branch Coordinator
Kathy Watson .....	Information Systems Manager





**Board of Directors**

Seated Left to Right: **Fred B. Jones**, *President & CEO*; **Julian L. Givens**, *Chairman of the Board* Standing Left to Right: **Charles Sturgill**; **Dennis B. Gambill**, *Vice President*; **J. David Vaughan**; **Thomas M. Jackson, Jr.**; **Carl J. Richardson**; **Jack E. Guynn, Jr.**; **Jean W. Lindsey**



**GNB Executive Officers**

**Jacky K. Anderson**, *President & CEO*; **Curtis A. Jennings**, *Senior VP*; **Dennis B. Gambill**, *Executive VP*; **Blake M.**